STATEMENT OF

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on the

NEW BASEL ACCORD

before the

COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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Thank you, Mr. Chairman and members of the Committee. I welcome the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the new Basel capital accord (Basel II). The proposals contained in the Third Consultative Paper (CP3) recently published by the Basel Committee on Banking Supervision, if adopted in the United States, would easily rank among the most important pieces of banking regulation in our nation's history.

Introduction

Basel II would change bank capital regulation in the United States in at least three important ways. First, rather than emphasizing simple pre-set minimum numerical capital ratios, Basel II would allow qualifying banks to use their own internal risk estimates as inputs to regulator-supplied formulas with the supervisors providing oversight and evaluation of the banks' ability to measure risk. Second, the new framework would formally adopt a "bifurcated" capital system in the U.S.: one set of rules for the large, complex and internationally active institutions, and another set for the balance of banks in the country. A third key change is that the total minimum regulatory capital charge under the new framework will include an explicit charge for operational risk. For those large institutions that qualify, the new framework may lead to reduced credit risk capital requirements for certain asset classes with additional capital held based on a flexible operational risk charge.

The FDIC supports the overall goal of Basel II, which is to create regulatory capital standards that are more sensitive to the economic substance of risks taken by these large banks, to limit their opportunities for regulatory capital arbitrage and to encourage sound risk management.

Over the years that Basel II has been under development, the Basel Committee and the U.S. federal supervisors have reached out to the industry and the public for comment on how to more closely align the proposed new framework with the ways that large banks measure risk. There have been quantitative impact studies to assess the potential impact on capital levels. We have been engaged in roundtables and discussions. Over this time, various aspects of the new framework have been refined and changed. Today, these refinements are reflected in CP3, which the Basel Committee recently released for additional comment.

The work in this country continues. The agencies intend to issue an Advance Notice of Proposed Rulemaking (ANPR) that will suggest how CP3 will be proposed for adoption in the U.S. and will seek additional comment on all facets of Basel II. As in the past, it can be anticipated that further changes to the framework may be required. The FDIC is committed to an interagency process to achieve the overall goals of Basel II and to fully understand its possible impact on bank capital levels and competitiveness.

The goal of more closely tying regulatory capital to banks' own internal assessment of risk is a good one. This goal is reached in part by using regulatory capital formulas that are based on ways of measuring credit risk and allocating internal capital that, to some degree, are already in place in large banks. The term “economic capital” is often used to refer to the amount of capital that should be allocated to an activity according to the results of a numerical loss analysis. Banks use models based on historical data and economic analysis to estimate future losses and the amount of income, reserves and capital needed to ensure their portfolios conform to management’s target level of risk.

These calculations produce different results for different bank activities. For example, the measured risk on residential mortgages might be much less than the measured risk on construction loans. The bank might use the economic capital measures to compute its risk-adjusted returns on the two activities and to assist its pricing decisions. This is a disciplined approach to risk management, and Basel II establishes firm expectations for banks to be rigorous in this respect. Basel II expands these risk management expectations beyond the area of credit risk and into the realm of operational risk.

Tying capital requirements closer to risk and increasing the incentives for disciplined risk management have the potential to improve the safety and soundness of the U.S. financial system. The FDIC supports enhancing the incentives for the largest banks in the U.S. to strengthen risk management processes. Tying regulatory capital closer to risk would reduce the incentives for banks to make uneconomic decisions designed to reduce regulatory capital.

At the same time, the domestic impact of Basel II has not been determined. Given current analysis, it seems likely Basel II will confer some degree of regulatory capital benefits on the limited number of banks that qualify, in exchange for their substantial investments in systems and infrastructure intended to improve risk management. The critical issue for the safety and soundness of our financial system is whether the improvements in risk management systems, and the resulting bank risk profiles, would justify the level of capital reductions that banks might ultimately realize.

It is virtually impossible to quantify at this time the potential changes in capital under Basel II. Basel II proposes floors by which risk-based capital would be allowed to decline by at most 10 percent the first year of implementation, and at most 20 percent the second year. After the second year, Basel II does not impose a floor on the minimum risk-based capital requirement. A quantitative study conducted in the fall of 2002 showed a wide range of changes in capital requirements for 19 large U.S. banks under the Advanced Internal Ratings Based (A-IRB) approach, with an average reduction in capital requirements for credit risk of 17 percent. In this study, the reduction in capital was offset by the operational risk capital charge, which was substantial. However, the amount of this operational risk charge was by necessity estimated using an approach that will not be used in the U.S.

The agencies understand that the results to date of the impact studies do not provide a full picture of the possible impact of Basel II. There are many moving parts to the proposal and the banks' participation in the study was on a best efforts basis. Moreover, in the U.S., leverage ratio floors and the demands of the marketplace would act as a constraint on the potential reduction in actual capital.

Still, these initial estimated results show that the Basel II formulas are potent instruments for affecting risk-based capital requirements in the U.S. This is a matter of great interest to the FDIC and we are committed to working with the other banking agencies as we move forward to more accurately assess the impact of the proposed new standards.

A significant business challenge for the banking and thrift agencies would be how to achieve interagency consistency in the application of these complex rules. Required capital charges will depend heavily on the ongoing judgments of banks and regulators about a variety of specific risks.

In addition to understanding the impact of Basel II on capital levels, we must also understand the significance of mandating two tiers of regulatory capital standards -- a bifurcated framework that will offer competitors different regulatory capital charges for similar assets. The critical issues in terms of the competitive playing field are whether the direct competitors of a core group of about ten large banks would feel forced to opt-in to the new framework for competitive reasons, and whether banks in the tier below those able to opt-in would be at substantial competitive risk.

To resolve these fundamental issues satisfactorily, much hard work remains. Given the magnitude of the issues, we must proceed carefully.

Capital Adequacy

The U.S. banking system has weathered the last ten years better than the banking systems of some other countries for a number of reasons. One significant reason is strong capital levels. Bank capital is subject to federal legislation and regulation because of its critical importance to the health and well-being of the U.S. financial system. An adequate capital cushion enhances banks' financial flexibility and their ability to withstand periods of adversity. As insurer, the FDIC has a vital stake in the adequacy of bank capital—as do our fellow regulators and all U.S. taxpayers. Congress recognized this important principle when it established the Prompt Corrective Action (PCA) requirements in the Federal Deposit Insurance Corporation Improvement Act. A critical aspect of the existing PCA regulations is the minimum leverage capital requirement. To be considered well-capitalized, a bank must have a ratio of Tier 1 capital-to-total assets (the leverage ratio) of at least five percent. Banks with leverage ratios under four percent are considered undercapitalized. The agencies agree that maintaining the minimum regulatory capital standards as reflected in the current PCA legislation and existing implementing regulations is important.

Capital is not the only thing needed for safety-and-soundness. The strong risk management that Basel II promotes is also essential. There is no denying that banks with good risk management and a lower-risk profile should be able to operate with somewhat less capital than more-risky banks. But there is also no denying that when the unexpected happens, the hard-earned benefits of risk management can evaporate overnight without adequate capital.

The sophistication of the measurement of economic capital can make it easy to lose sight of the fact that, in reality, no one knows the range of potential future losses for a given activity, or the associated probabilities. Certain risk management practitioners express great faith in the calculation of economic capital, and believe that the regulatory capital standard should in all instances be less than the economic capital amount. The idea behind this philosophy is that banks tend to be forced out of low-risk activities where regulatory capital requirements exceed economic capital requirements. It is this belief that gives us concern about a clash of expectations about Basel II between a number of prominent risk management practitioners on the one hand, and the FDIC and our fellow bank regulatory agencies on the other.

As the regulators move forward to finalize our views on Basel II, we need to proceed cautiously. Where a proposal seems to run counter to established U.S. supervisory practice, we need to ask whether the established practice should be re-examined in light of the proposed new rules, or whether the new rules need to be re-examined for U.S. purposes.

Basel II is the object of intense scrutiny and comment. Changes have been and will be suggested by banks in many areas, including the treatment of commercial real estate, credit cards (and the related issue of future margin income), mortgages, securitizations, and capital recognition of certain risk-mitigating activities. The potential for many moving parts could make it difficult to evaluate the capital impact or the competitive impact of Basel II. Yet, we believe that we must achieve a better understanding of these issues before the bank regulatory agencies commit the U.S. to the new framework.

Interagency Consistency

Basel II would provide banks and supervisors some flexibility to determine what capital would be held on an ongoing basis. The degree of conservatism to apply to a particular situation would often be a judgment call. Is the loss given default on a secured commercial loan likely to be 20 percent or 40 percent? Capital for that loan would double, or be cut in half, depending on the answer -- and the answer could well depend on a mix of historical data, the specific underwriting methods used by individual banks and the specific analytical techniques banks use to make their case. Supervisors would need to validate – uniformly and consistently across banks – the answers to such questions. In this new framework, regulators must be prepared to challenge the modeled outputs of sophisticated risk measurement systems of the largest U.S. financial institutions, a difficult and demanding task. It will require courage and discipline to respond to this new challenge.

Much progress has been made by the regulators and the industry in deciding how this validation might be done. Interagency guidelines are being drafted and implementation approaches are being discussed. The FDIC has an active interest in the development of a sound approach to ensure the consistent and uniform review of bank risk measurement systems under Basel II.

A Level Playing Field

Capitalism, with its inevitable winners and losers, is about competition. It is the job of the regulators to make certain that the competition is fair. In our capitalist system, one of the key functions of regulation is to ensure the rules do not display favoritism and that the competitive struggle is carried out on equal terms. We need to evaluate Basel II against this standard before committing to implement it in the U.S.

The proposed agreement raises important questions. The fundamental question is what are the economic benefits of the regulatory capital relief some banks might realize under Basel II? Conversely, what are the costs of additional capital they might be required to hold for certain activities? Would small or mid-sized regional banks, unable to qualify for the new framework, become acquisition targets of Basel II banks whose reduced capital has boosted their returns on equity? Would a large credit card bank that must hold capital for unused credit card lines be at a disadvantage to a non-Basel bank that faces no such requirements? Would a securitizing regional bank that is forced to deduct most of its retained interests from capital be at a disadvantage to a Basel bank whose deductions from capital would now be capped? What would be the ramifications of significantly reduced capital requirements for Basel banks on specific assets held by banks of all sizes, such as mortgage-backed securities issued by the federal government-sponsored enterprises?

The Basel II formulas are designed to work for large diversified portfolios, and the capital requirements they produce might be too low for most small banks. The Basel framework also requires significant systems investments at a level likely beyond the reach of – and not essential for – small institutions. Therefore, it is not practical to think that any competitive concerns that may exist could be resolved simply by allowing all banks access to the Basel framework.

To a large extent, the banking system in the U.S. is already a two-tier system, with large financial institutions possessing the vast majority of U.S. bank assets. Still, we must evaluate thoroughly whether Basel II will unnecessarily disturb this current, albeit divided, field of competition. Even though the industry may already be divided between the large and complex and the small and less complex, banking supervisors must understand fully whether Basel II adds significant additional competitive pressures or would trigger additional industry consolidation. The ANPR will seek input from all interested parties, including banks that believe they will be competitively harmed if they cannot embrace the Basel II framework.

Conclusion

An Advance Notice of Proposed Rulemaking will be issued this summer and will reflect the U.S. banking and thrift agencies' views on how Basel II would be adopted in the U.S. More importantly, it will present issues and concerns, and raise questions to the industry and the public. The comments will provide invaluable insight to many of the key concerns being raised by the agencies, and by Congress.

Given the importance of these issues, it is vital that we treat the implementation of Basel II in the U.S. as we would any other proposed regulation—with a dose of skepticism, a willingness to entertain the discussion of options, and a commitment to fully explore potential costs and benefits before reaching a final decision. We need to listen carefully to comments that will be received in the rulemaking process to ensure we address these threshold issues.

It also is important that the financial services industry, the Congress, and the banking agencies have a full opportunity to review the response to the ANPR and achieve a better understanding of the impact of this proposed agreement before we commit the U.S. to the Basel II approach. The FDIC has no interest in delaying the agreement and its implementation beyond what is necessary to address the issues we have raised and to understand the impact of this new system of capital regulation.

I have full confidence that this interagency process will work and will arrive at an appropriate outcome. The FDIC will continue to remain fully involved in this process and will work to ensure that the goals of Basel II and of Congress are being met as the process moves forward.

Thank you for the opportunity to present the views of the FDIC.